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Attachment 5

March 15, 2006

AGENDA ITEM 15-A

TO: MEMBERS OF THE BOARD OF ADMINISTRATION

I. SUBJECT: House Resolution (HR) 4291 (Barney Frank, (D-MA)) – As Introduced November 10, 2005

The Protection Against Executive Compensation Abuse Act

II. PROGRAM: Federal Legislation

III. RECOMMENDATION: Support

This bill would increase disclosure of executive compensation packages to include all types of compensation (whether present, deferred, or contingent) paid or to be paid; subject executive compensation plans to a shareowner vote, require disclosure of compensation policies used to determine such compensation, and require policies to recover compensation that was later revealed to have been inappropriately awarded.

IV. ANALYSIS:

The Protection Against Executive Compensation Abuse Act seeks to address the problem of excessive executive compensation by requiring greater disclosure of executive compensation plans and subjecting such plans to a shareowner vote. The bill would not set any artificial limits on executive compensation itself. The bill also requires companies to adopt policies providing for the return of executive compensation that was later revealed to have been inappropriately awarded. If enacted, the Securities and Exchange Commission (SEC) would execute the bill's provisions in an open rulemaking process with opportunity for notice and comment.

Background

According to a recent survey on CEO compensation,[1] the median total compensation received by CEOs increased 30 percent in fiscal year 2004, with the average increasing 91 percent--driven by 27 CEOs receiving compensation over 1,000 percent greater than their previous year's pay. The increase in 2004 comes on top of median increases of 15 percent for fiscal 2003 and 9.5 percent in fiscal 2002.

In 1991, the average large-company CEO received approximately 140 times the pay of an average worker; in 2003, the ratio was about 500:1. While taking other variables into consideration, such as company size, performance, industry classification, and inflation, studies find executive compensation is far higher today than in the early 1990s.

A separate study found that in 1993, the aggregate compensation paid to the top five executives of U.S. public companies represented 4.8 percent of company profits; by 2003 the ratio had more than doubled to 10.3 percent and the total amount paid to these executives during this period is roughly $290 billion.[2] In addition to concerns about the excessive compensation packages, the report notes that compensation schemes may give executives an incentive to avoid their duty to shareowners, for example:

- Earnings Manipulation: Because accounting standards like Financial Accounting Standards Board (FASB) 133 are not always clear, excessive compensation provides executives an incentive to use accounting methods that maximize his/her compensation.

- Unprofitable Mergers/Acquisitions: Because senior executives often receive additional compensation when they acquire a new company or sell their current one, there is a conflict of interest between the executives' interest and the company's interest.

Compensation programs are a valuable tool available to companies to attract, retain, and motivate key employees, as well as align their interests with the long-term interests of shareowners. Poorly designed compensation packages can have negative effects on the company and its shareowners by incentivising short-term oriented or self-interested behavior. Conversely, well designed compensation packages can help align management with owners and drive long-term superior performance.

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[1] The Corporate Library, "CEO Pay Survey – 2004" and "CEO Pay Survey – 2003."
[2] Lucian Bebchuk, Harvard Law School; National Bureau of Economic Research (NBER) and Yaniv Grinstein, Cornell University; Samuel Curtis Johnson Graduate School of Management, Oxford Review of Economic Policy, Vol. 21, No. 2, "The Growth of Executive Pay" 2005.

CalPERS' Action Regarding Executive Compensation

In recognition of these concerns, CalPERS staff provided the Investment Committee with recommended amendments to CalPERS' Corporate Governance Core Principles and Guidelines regarding executive compensation and shareowner rights for consideration during its June 17, 2002 meeting.

During the meeting, the Investment Committee approved:

1. An addition to CalPERS' website dedicated to executive compensation issues.
2. Direction to staff to sponsor or co-sponsor, on a periodic basis, forums covering compensation.
3. Amendments to CalPERS' Corporate Governance Core Principles and Guidelines related to policy positions on compensation.

In addition, the Committee directed staff, in lieu of expensing stock options, to:

1. Develop recommendations for how CalPERS, as a leading institutional investor, can effectively implement a shareowner activism role.
2. Develop a model for disclosure to promote to regulators and in the marketplace.
3. Develop best practices policies such as performance or index-based options to promote in the marketplace.
4. Develop recommendations about consequences or penalties for companies that are implementing stock option plans that are inimical to long-term shareowner interests.
5. Research the attitude of investors – institutional, small, mid-size and individuals.

In June 2003, CalPERS adopted policy positions related to executive compensation. The policy positions addressed proxy voting in relation to equity compensation plans, provided a model executive compensation policy framework (for corporations to utilize) and proposed an executive compensation analytical model. Staff continues to implement the June 2003 Executive Compensation Program through existing programs such as the Focus List and proxy voting function.

On November 17, 2004, the CalPERS Board approved a three-year Corporate Governance Executive Compensation Strategic Plan in order to raise the level of accountability of public company boards and compensation committees to shareowners. This Strategic Plan is supported by the following Mission, Objective and six specific Strategies.

Mission

CalPERS' mission is to achieve comprehensive reform of executive compensation practices by advocating, influencing, and educating companies to properly align the interests of boards and management with those of shareowners.

Objective

Support CalPERS' mission by advocating national reform, raising the level of accountability of boards and compensation committees at CalPERS portfolio companies, and building a broader coalition of national support for CalPERS' effort to align executive compensation practices with shareowner interests.

Macro Economic Strategies

1. SEC engagement
2. SRO/Exchange engagement
3. Compensation Consulting Industry engagement

Micro Economic Strategies

1. Engaging the largest companies to promote compensation reform
2. Enhancing compensation committee accountability
3. Recognizing pay-for-performance leaders

Proposed Changes

Require Executive Compensation Plans

The bill would require that public companies include in their annual report and accompanying proxy solicitations a comprehensive "Executive Compensation Plan." This Executive Compensation Plan must be approved by shareowners and include:

- *Full Disclosure of Principal Executive Officer's Compensation* - including any and all types of compensation (whether present, deferred, or contingent) paid or to be paid, such as the estimated value of accrued pensions, golden parachute agreements, the market value of any benefit received (e.g., personal use of private jets/company apartments) and other hidden forms of compensation);
- *Full Disclosure of Compensation Policies for Principal Executives* - including the short and long-term performance measures or targets that will be used to determine the principal executive's compensation (and whether such measures were met in the preceding year); and
- *A Company Policy for Recapturing Compensation That Is Subsequently Revealed to be Inappropriately Awarded* (i.e., "clawback" policies) - such as compensation paid as a result of fraud/misrepresentation or that is inconsistent with the compensation policies, or when the company pays bonuses/grants stock options to executives for meeting performance targets only to learn that these numbers were inaccurate and must be restated.

To limit the burden on smaller companies, the term "principal executive officers" is limited to the CEO or an executive acting in a similar capacity for companies with less than $250 million in total assets; the CEO and the next two highest paid executives for companies with more than $250 million but less than $500 million in assets; and the CEO and next four highest paid executives for companies with more than $500 million in total assets.

Require Shareowner Approval of Golden Parachute Packages

The bill would also require that shareowners separately approve any additional compensation for top executives that coincides with the sale or purchase of substantial company assets. This provision is designed to empower shareowners to protect themselves from senior management's natural conflict of interest when negotiating an agreement to buy or sell a company while simultaneously negotiating a personal compensation package.

Require Clear and Simple Disclosures of Compensation Statements on the Company's Website

The bill would require that companies include on their websites clear and simple disclosures on the company's compensation filings made to the SEC. Rather than forcing shareowners to regularly monitor and decipher the SEC's "EDGAR" database, shareowners could get this information right on the company's website.

Legislative History

2005 In House Financial Services Committee. HR 3031 "The Corporate Advance Disclosure Act of 2005" (Terry Everett (R-AL)) amends the Securities Exchange Act of 1934 to require an issuer to provide at least 60 days advance notice to the Securities and Exchange Commission if it creates, substantially increases, or funds any non-qualified pension plan for which a director or executive officer is the beneficiary. The bill also requires implementing SEC rules to require that the disclosure separately state each creation, increase, or funding with respect to each such director or officer. CalPERS' position: None

Issues

1. Arguments by Those in Support

   Excessive CEO pay takes money out of the pocketbooks of shareowners, including the retirement savings of America's working families. Moreover, a poorly designed executive compensation package can reward decisions that are not in the long-term interests of a company, its shareowners and employees.

Pay decisions are one of the most direct ways for shareowners to assess the performance of the board.

To properly perform this assessment, shareowners must have comprehensive, accurate and clear information detailing long- and short-term compensation to executives. The provisions in the Protection Against Executive Compensation Abuse Act that call for full disclosure of information about all compensation paid to executives and the performance measures tied to compensation would assist shareowners in this effort by requiring companies to disclose the performance measures used to set executive pay, and will require executives to return their compensation if these benchmarks are not met.

Organizations in Support: American Federal of Labor-Congress of Industrial Organizations (AFL-CIO), Council of Institutional Investors (CII), the Corporate Library

2. Arguments by Those in Opposition

There is no known opposition at this time.

3. Securities Exchange Commission Action Regarding Executive Compensation

H.R. 4291 has some goals in common with a proposal that was given preliminary approval by the SEC on January 17, 2006, and is now in its public comment period. Both measures aim to increase disclosure of executive compensation, but the SEC proposal is not as demanding as H.R. 4291 and, does not include "clawback" provisions.

The SEC proposal would affect disclosure in proxy statements, annual reports and registration statements. The proposals would require most of this disclosure to be provided in plain English, would modify the current reporting requirements of Form 8-K regarding compensation arrangements, and would refine the currently required tabular disclosure and combine it with improved narrative disclosure to elicit clearer and more complete disclosure of compensation of the principal executive officer, principal financial officer, the three other highest paid executive officers and the directors.

New company disclosure in the form of a Compensation Discussion and Analysis would address the objectives and implementation of executive compensation programs - focusing on the most important factors underlying each company's compensation policies and decisions. Following this new section, executive compensation disclosure would be organized into three broad categories:

A) Compensation over the last three years;

B) Holdings of outstanding equity-related interests received as compensation that are the source of future gains; and
C) Retirement plans and other post-employment payments and benefits.

4. Instances where the Language of the Bill Either Imposes Definitions or Specificities that CalPERS' Policies Do Not Currently Address

The following three points are generally consistent with CalPERS' viewpoint pertaining to executive compensation; however, the specific language of the bill is not clearly addressed by CalPERS' policies:

- Requires disclosure of a company policy (within the Plan) for recapturing any form of incentive compensation that subsequent financial results show is unjustified;
- Requires separate shareowner approval of additional compensation (Golden Parachutes) for top executives that coincides with the sale or purchase of substantial company assets; and
- Requires clear and simple disclosure of compensation statements on the company's website.

5. Legislative Policy Standards

The Board's Legislative Policies do not address the issues in this bill. However, staff is recommending a support position because the following points as summarized from the bill are consistent with the Board's Executive Compensation Strategic Plan:

- Requires companies to include in their annual report and accompanying proxy solicitations a comprehensive Executive Compensation Plan ("Plan") that must be approved by shareowners;
- Requires disclosure (within the Plan) of any and all types of compensation paid to top executives; and
- Requires disclosure of compensation policies (within the Plan) including short and long term performance measures used to determine top executive compensation and whether such measures were met in the preceding year.

V. STRATEGIC PLAN:

This item is not a product of the CalPERS strategic plan, but an ongoing responsibility of the CalPERS Office of Governmental Affairs.

VI. RESULTS/COSTS:

There are no known costs at this time.

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